Santander Asset Management

State of Play

Stick or twist?

2 March 2023

In a quiet period for macro-economic data, investors remain nervous about the road ahead. Later this month, central banks meet again to assess whether the aggressive increase in rates over the last year has been enough to bring down above target inflation. The most recent indicators show consumption remains healthy and unemployment is near record lows. So, if you were a policymaker, what would you do? Stick or twist? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

- A bumper January followed by a nervous February
- Year to date asset class review
- Why did investors become nervous in February?

A bumper January followed by a nervous February

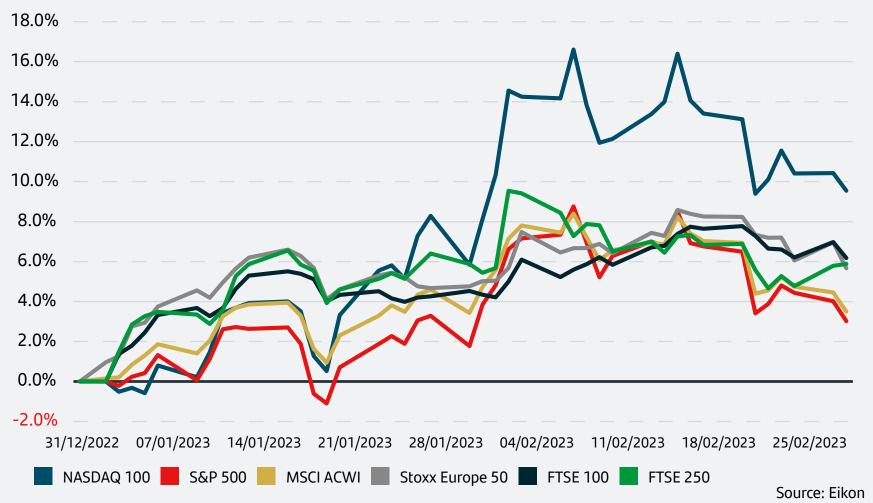
After such a bruising 2022, January came as a light relief for investors as all asset classes made a strong recovery. The question for market participants was whether this momentum would endure longer than the previous relief rallies seen throughout last year. This is where investors see a buying opportunity after a sharp fall in asset prices and invest, pushing values back up until poor economic news bursts the bubble and values begin to fall once more. This rhythm has been maintained throughout the last 18 months, making life very difficult for retail investors as sustained volatility makes life very uncomfortable and triggers strong emotions. For some, these emotions become too strong, and they react.

The key question for the market is: What comes next? Let's first understand what has happened so far this year in more detail and then consider the factors that will affect momentum in the coming weeks and months.

Year to date asset class review

January was one of the strongest opening months for an investment year since records began. Hopes of easing inflation and slowing economic consumption pointed to central banks pausing rate rises sooner than had been priced in before the year's-end, prompting asset prices to soar. As I mentioned last week, the UK delivered over 4% in January but slightly lagged Europe, emerging markets, and the NASDAQ 100 in the US. Government bonds were steady, while UK corporate bonds benefited from falling yields helping boost values.[1]

Asset class returns year to date



Source: Eikon
Data as at 28 February 2023

Bond yields have fallen considerably since the mini-budget crisis at the end of September last year. Bond yields act inversely to their value, so as yields fall, values rise. Investors benefit from a fixed income (hence their investment name) while also seeing the value change depending on the prevailing outlook for interest rates. If markets expect central banks to cut rates earlier than anticipated, yields immediately reflect the changing view. As you can see from the chart below, UK Government Bond (Gilts) 10-year yields hit a recent high at the end of September before retreating back to 3%. Briefly in November, yields rose again before falling in December on hopes that the outlook for a pause in central bank rate rises was earlier than thought. You can see February shows how the market views on future interest rate rises have recently changed pushing the yield from 3% to nearly 4% by the month-end.

UK 10 year government bonds (Gilts) yields

Source: Eikon
Data as at 28 February 2023

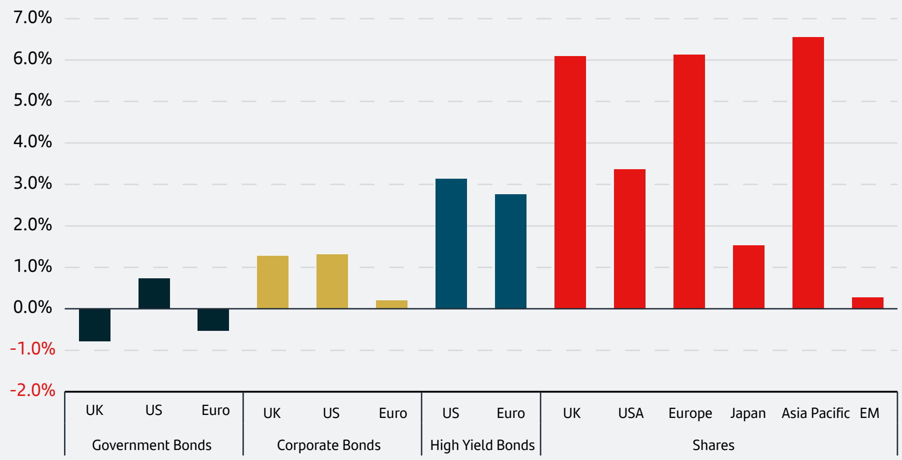
Why did investors become nervous in February?

Fresh jobs data in the US shocked markets as the US economy added over half a million jobs in January, nearly three times the level forecast as the unemployment rate fell to 3.4%.[2] This, coupled with stronger retail sales than anticipated and core inflation remaining stubborn, triggered investor concerns about the central bank's future response. In the last Federal Reserve (Fed) meeting, Jerome Powell, the Chairman, commented that the task of tackling inflation was not yet complete and they were prepared to go higher on rates if necessary to see the job through. As you can imagine, the data shows the US economy is still very strong. With a tight labour market and wage settlements still elevated, market participants realise this may lead to a larger rate increase than currently priced in when the Fed meet later this month to decide.

The challenge facing policymakers when they meet later in March is deciding how far to raise rates without inflicting long-lasting damage on future economic growth. Do they stick or do they twist? Central banks recognise the threat inflation poses to future growth stability and have been extremely aggressive over the last year in raising rates to blunt rising prices. However, as I have mentioned in recent weeks, raising rates is a blunt instrument. The principle of higher borrowing costs for individuals and businesses will reduce consumption, which in turn should see prices fall over time. However, any rate rise takes many months to impact future buying decisions and, in turn, the level of demand in the economy. Going too high and too far before pressing pause may mean any economic slowdown becomes a deeper recession than was necessary to bring inflation down to the desired target of 2%.

In terms of the outlook, until investors are clear on when policymakers are prepared to press the pause button and clear evidence emerges of a sharp decrease in rising prices, along with slowing economic demand, they are likely to remain nervous. For retail investors, this simply means the next few weeks, perhaps a few months, will remain volatile. It doesn't, however, change the prospects for investments over the long-term. Ordinarily, investing is about time, patience and matching your financial plan to your desired objectives and risk comfort. At present, with sharp rises in interest rates, investors can access much higher interest rates on their savings than we have become used to in the recent past. However, these elevated rates are unlikely to persist over the long term. As inflation falls to the desired target and economic growth becomes muted or a recession occurs, it will be incumbent on policymakers to reverse some of the recent rises to re-stimulate demand. What is clear, is that the challenge of navigating this narrow path between tackling inflation and avoiding crashing the economy is incredibly difficult. We will watch to see with interest what unfolds.

Year to date performance



Source: Eikon
Data as at 28 February 2023

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 28 February 2023.

[1] FE Analytics, 28 February 2023
[2] Investing.com, 28 February 2023